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Why We Don't Have to Choose between Social Justice and Economic Growth:

The myth of the equity/efficiency trade-off

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Summary

Mainstream economic theory holds that there is a fundamental trade-off between equity - a reasonably equal distribution of income and wealth - and efficiency - or economic growth. The basic idea is that societies that care too much about promoting equality will pay a price in terms of slower growth. Today, this theory is combined with the common argument that any advanced industrialized country that hopes to copy the recent economic success of the United States must buy into the high inequality U.S. social model.

The purpose of this paper is to critique this basic argument on both empirical and theoretical grounds, and to show that there are positive linkages between relative equality and good economic performance.

The economic and social performance of seven countries which are broadly representative of three different socio-economic models - "liberal," "social market" and "social-democratic" - are compared. The central conclusion is that, in the 1990s, there was no clear association between inequality and economic growth, and that two low-inequality countries - the Netherlands and Denmark - did very well in both economic and social terms. At a minimum, this indicates that it is possible to achieve high growth and low unemployment without sacrificing the goal of social equity. Moreover, the paper shows that growing differences in income distribution among these seven countries are primarily caused by a shift to greater inequality in the so-called "liberal" countries; there has been no universal trend towards greater inequality.

The paper surveys recent studies which show that equality producing institutions and policies do not necessarily carry a significant price in terms of poorer economic performance. Specifically, it points out that widespread collective bargaining and labour market regulation can maintain low levels of earnings inequality without blocking job growth or needed business investment, and that the relatively high taxes needed to finance "generous" redistributive transfers and accessible public services do not necessarily have negative impacts on growth. Going one step further, the experience of

some countries suggests that reform and renewal of these institutions and policies -rather than their erosion - can have positive impacts on economic performance.

A final section of the paper critiques the general argument that "globalization" forces modern societies to abandon the goal of equality if they are to effectively compete in the international market. The paper points out that while changes to social and economic policies intended to promote equity may well be necessary, and while it is not easy to balance the goals of equity and efficiency, it is still possible for modern societies to "grow together" rather than "grow apart." This general conclusion is highly relevant to the debates currently underway about the degree to which Canada must become more like the U.S. in social terms, if we are to match their success in economic terms.

- Section I: Introduction
- Section II: The Equity/Efificiency Trade-off in Practice: Empirical evidence for North American and European OECD countries in the 1990s
- Section III: Which Model Works Best? A comparison of economic and social performance in the 1990s
- Section IV: Causes of Success and Failure
- Section V: What About Globalization?
- Section VI: Conclusion
- Acknowledgements
- Endnotes

[Home Page] [E-mail] [Page d'accueil]

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Sommaire

Pourquoi il n'est pas nécessaire de choisir entre la justice sociale et la croissance économique : *Le mythe du compromis entre ce qui est équitable et ce qui est efficace*

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Selon la théorie économique courante dans la société, il y a un besoin fondamental de faire des compromis entre ce qui est équitable - une répartition raisonnablement égale du revenu et de la richesse - et ce qui est efficace, c'est-à-dire la croissance économique. Le concept de base est que les sociétés qui portent trop attention à encourager l'égalité finiront par en payer le prix en termes d'une croissance plus lente. De nos jours, cette théorie se combine au raisonnement répandu que tout pays industrialisé qui a l'intention de copier la réussite économique récente des États-Unis, doit du coup adopter le modèle américain d'une très grande inégalité sociale.

Le présent exposé a pour objectif de critiquer ce principe de base tant sur le plan empirique que théorique, et de démontrer qu'il y a des rapports positifs entre une égalité relative et une bonne rentabilité économique.

Nous comparons le rendement économique et social de sept pays qui sont en gros représentatifs de trois modèles socio-économiques différents, soit le modèle libéral, le modèle du marché social et le modèle de la social-démocratie. Tout converge à conclure que, dans les années 1990, il n'y a pas de lien évident entre l'inégalité et la croissance économique et que deux pays avec un système très égalitaire - les Pays-Bas et le Danemark - s'en sortent très bien tant sur le plan économique que social. Pour le moins, cela montre qu'il est tout à fait possible d'atteindre une forte croissance et un faible taux de chômage sans avoir à sacrifier l'objectif de vivre dans une société équitable. En outre, l'exposé montre que les différences croissantes dans la répartition du revenu parmi ces sept pays sont principalement causées par une tendance vers une plus grande inégalité dans les pays soi-disant «libéraux»; il n'y a pas de tendance universelle vers une inégalité croissante.

Dans ce document, nous examinons des études récentes qui corroborent que des

institutions et des politiques publiques favorisant l'égalité n'entraînent pas forcément de lourdes conséquences en termes d'un plus mauvais rendement économique. Plus précisémment, on y montre que la pratique généralisée des conventions collectives et la réglementation du marché du travail peuvent maintenir une moindre inégalité des salaires sans pour cela bloquer la création d'emplois ni l'investissement nécessaire aux affaires, et que les impôts relativement élevés nécessaires pour financer des transferts redistributifs «généreux» et des services publics accessibles n'ont pas forcément des conséquences négatives sur la croissance. En poussant un peu plus loin le concept, l'expérience de certains pays suggère que la réforme et le renouvellement de ces institutions et ces politiques - plutôt que leur érosion - peuvent avoir des effets positifs sur le rendement économique.

La dernière section de l'exposé fait la critique de l'argument généralement avancé que la «mondialisation» oblige la société moderne à abandonner tout principe égalitaire si elle veut pouvoir être compétitive sur le marché international. On souligne que même s'il est peut-être nécessaire d'apporter des changements aux politiques sociales et économiques visant à promouvoir l'équité, et que même s'il n'est pas facile d'équilibrer les objectifs de l'équité et ceux de l'efficacité, il est encore possible pour les sociétés modernes de «grandir ensemble» au lieu de «faire grandir l'écart». Cette conclusion générale est extrêmement pertinente dans le cadre des débats actuels sur le degré auquel le Canada devrait davantage se conformer au modèle social américain, afin d'arriver à rivaliser avec la réussite économique des États-Unis.

L'exposé est disponible en format intégral, en anglais seulement, sur le site web du CCDS : Why We Don't Have to Choose between Social Justice and Economic Growth: The myth of the equity/efficiency trade-off

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Section I: Introduction
The Big Trade-off in Theory and Contemporary Debate

The idea that society faces a fundamental trade-off between equity and efficiency, between social justice and economic growth, is a staple of both economics textbooks and contemporary political debate. The basic premise is that too much social effort to promote an equal distribution of income or wealth distorts the necessary functioning of (inequality generating) incentives and disincentives in a market economy and thus, carries a cost in terms of lost income and future economic growth. The classic formulation of this idea was put forward a quarter of a century ago by U.S. economist, Arthur Okun, who wrote that inequality reflects "a system of rewards and penalties that is designed to encourage effort ...**The pursuit of efficiency necessarily creates inequalities. And hence society faces a trade-off between equality and efficiency.**"[1]

The typical economics textbook presentation of the issues concedes that, from the point of view of maximizing economic welfare at a given moment in time, there is little question that income equality achieved through redistribution is optimal. (The "utility" of more income for the poor is greater than the loss of "utility" on the part of the rich.) However, the central issue is posed as the relationship between equity and economic growth. Do measures to promote greater equality of income such as redistributive taxes and transfers diminish total output and income? In other words, does "sharing the pie" result in a smaller pie, and thus smaller slices even for those who benefit from redistribution in a simple static analysis?

The textbook presentation of the issues argues that the key mechanisms of redistribution to achieve social equity - that is, taxes and the income transfers they finance - carry significant costs for efficiency. In this view, taxes and transfers are said to reduce incentives to work, savings and investment, thus resulting in labour market "rigidities," unproductive dependency, foregone work effort in the present, and reduced investment in the future. Key mechanisms to achieve greater equality of market income - such as collective bargaining and legislated employment standards - are also said to be economically inefficient because of the resulting "distortion" of wages.

The question of a trade-off is critically important to advocates of progressive economic and social policy who want to achieve a more equal distribution of income and opportunities than would arise under pure "free market" mechanisms. Those who want to redistribute income to achieve social justice, or to promote an initially more equal distribution of market income, will face an uphill fight if their opponents can successfully

demonstrate that this would result in a large overall income loss, and particularly if their opponents can show that low-income households are actually better off in absolute terms in a high inequality but high income society.

The question of who benefits from trading-off equity for efficiency is often not explicitly considered. For example, in the recent U.S. experience, a pertinent question to ask is: Boom for Whom? The U.S. may be a rich society in dollar terms compared to many others, but income is distributed profoundly unequally. As a result, many Americans are excluded from the "average" level of prosperity and they fare worse than ordinary citizens in other, "poorer" societies. Canadians, on average, currently have incomes at about 80% of the U.S. level (GDP per capita in 1997 adjusted to equalize purchasing power), but analysis shows that it is only the top layer of U.S. citizens who are significantly better off than Canadians at a comparable point in the earnings distribution. The median Canadian household - one at the precise mid-point of the national income distribution - is almost as well off in terms of their purchasing power as the median American household, and the income privilege of being American only becomes significant for about the top 20%.[2] (Calculation is for real after-tax household income, adjusted for differences of purchasing power and household composition.) Low-income Canadians (the bottom 25%) are significantly better off than low-income Americans in terms of their absolute purchasing power. This result reflects the combined workings of a larger and more redistributive tax/transfer system operating on top of a modestly more equal initial distribution of market incomes in Canada.

At some point, however, income gains from faster economic growth can be expected to eventually make even lower income households better off than similar households in lower income but more equal countries. Lower income households in the U.S. have indeed finally benefited from very low unemployment rates, even if a lot of the employment growth has been in low-wage jobs. And there has been some real income growth for low-income households in the U.S. since 1997 as the benefits of the economic expansion have finally started to percolate downwards.[3]

It is generally recognized that the U.S. and other "liberal" countries such as the United Kingdom have both relatively high levels of earnings inequality and high levels of after-tax household income inequality, and that income inequality in these countries has increased throughout the 1990s despite sustained growth. But strong economic and job growth are often cited as results that make this a good trade-off for society. Strong economic growth in the U.S. in the 1990s supposedly demonstrates the virtues of the "liberal free market" model, while weaker growth in Canada and in much of Europe is said to reflect the costs of a "kinder, gentler" form of capitalism that is associated with higher taxes and transfers and more labour market regulation.

A key theme in the influential 1995 OECD Jobs Study was that "flexible," U.S.-style labour markets deliver strong employment growth compared to the regulated labour markets of "sclerotic" continental Europe. In this view, overly generous welfare states are thought to discourage the growth of lower wage jobs and to encourage costly "dependency," while relatively equal wage structures impede the necessary reallocation of workers between jobs by "distorting" market signals. Low taxes, as in the U.S., are seen as necessary to reward effort and stimulate savings and investment. The market delivery of services, as in the U.S., is also seen as inherently more efficient than the public provision of services.

The concept of a fundamental equity/efficiency trade-off has been a very prominent feature of recent policy debate in Canada. It is frequently argued that a downward harmonization of Canadian taxes to, or even below, the U.S. levels for corporations and mobile high-income earners is needed in order to boost growth and productivity in an ever more closely integrated continental economy. But such an agenda would erode the capacity of the tax and transfer system to reduce market income inequality, since the

progressivity of the personal income tax system would be reduced, and growing fiscal resources would be directed to tax cuts, rather than to additional spending on income transfers such as Employment Insurance and social assistance, or to other equality enhancing public programs and social investments.

The total tax share of GDP is significantly higher in Canada than in the United States - 42.8% vs. 31.0% of GDP in 1999 - mainly because upper-middle and high-income earners incur a significantly higher income tax burden. Canada remains a modestly more equal society than the U.S. because of the greater relative size of the tax/transfer system and higher levels of provision of public services.

These differences have, however, been eroded as total public expenditures on programs fell from 41.4% to 36.4% of GDP between 1990 and 1999. Cuts in transfers, combined with increased inequality in the distribution of market income, have increased income polarization and inequality. After years of relative stability in after-tax income shares, the share of the bottom 20% of families fell from 7.7% to 7.1% between 1995 and 1998, while the share of the top 20% rose from 37.3% to 38.8%. Over this period, the share of the top quintile increased at the expense of all other quintiles, and the Gini coefficient of after-tax income inequality increased significantly from .297 to .315.[4]

Growing after-tax income inequality likely reflects still weak labour market conditions in a period of economic recovery, continued high unemployment and levels of precarious work at the bottom to middle of the income distribution, unequal wage and salary growth across income groups, and, as importantly, the impacts of transfer cuts, particularly cuts to Employment Insurance and social assistance that impact younger households.[5]

Given this growing gap between the rich and poor, and the badly stretched public services as a result of the recent cuts, the current difference between Canadian and U.S. tax shares is probably insufficient to meet equity goals and maintain our social distinctiveness, even if growth and unemployment rates were to converge with those of the U.S.

The 2000-01 federal budget attempted to maintain some balance between the "growth agenda" of tax cuts and the "social agenda" of reinvestment in programs such as the Canada Child Tax Benefit, but most observers agreed that the emphasis was tilted to the former. Growth is indeed the only morally defensible case for a regressive strategy of reducing taxes for high-income earners while foregoing major social re-investments, and the Business Council on National Issues explicitly argued the case for "growing the pie" in its 1999 pre-budget submission to the House of Commons' Finance Committee.

The argument in favour of growth through tax cuts and continued restraint in social spending at a time of growing inequality and social exclusion understandably draws fire from social advocacy groups. Far too conveniently, it equates the self-interest of the relatively privileged with the national interest. And social advocates rightly stress the need to maintain a larger and more progressive fiscal base than the U.S. and a stronger set of social programs if we are to achieve lower rates of poverty, insecurity and income inequality. But social advocates also should - and largely do - recognize the need for stronger economic growth to get more and better jobs, to drive market income growth, and to produce a stronger fiscal base in order to finance transfers and public services. The argument that growth **could** enhance equality by reducing unemployment and by boosting tax revenues is powerful because it is basically true.

The linkages between economic growth and income inequality are complex, but few people would disagree that growth can potentially promote greater equality through two key channels.

First, economic growth (in excess of trend labour productivity growth) is needed to create

jobs. More hours of work for the unemployed and underemployed will increase the incomes of low-income groups. This is particularly true in countries which have relatively ungenerous income support programs for the unemployed.

Second, growth increases social wealth and with it, the capacity to finance more generous income support programs for those who are excluded from the labour market or who, for other reasons, have low market incomes. It is entirely possible for growth to produce more inequality of incomes, particularly when full employment is reached, if the distribution of market incomes is highly unequal. But it is more likely for inequality to increase in a slow growth economy that has high unemployment and a high level of "dependence" on income transfers.

Put another way, the optimal conditions for shared progress are high levels of employment in a job market which provides relatively equal wages, combined with a tax/transfer system large enough to provide a decent income to those who are excluded from the labour market because of old age, infirmity, disability, and so on.

Changes in the job market have led most analysts to agree that modern welfare states must also be prepared to supplement employment income for groups at high risk of low income, such as young working families, single parents with children, and very low skilled workers, although there is no clear consensus on the respective roles of labour market regulation and government-financed income supplements to raise low wages.

The more controversial and unexplored linkage is from equality and inequality of incomes to growth. As noted, the dominant argument is that measures to blunt inequality - such as regulated labour markets which produce relatively equal wages, and progressive tax/transfer systems - will carry a price in terms of lost growth. Fortunately, however, there is growing evidence that we do not have to choose between efficiency and equity, between growth and equality, but can, in fact, get both at the same time.

Economic theory is increasingly critical of the simple trade-off story and increasingly stresses the positive rather than negative linkages between low levels of income inequality and growth. Moreover, empirical studies have undermined the notion of a consistent negative trade-off in favour of the view that equality itself is growth-enhancing and that initially more-equal societies grow faster.

A major survey of the literature made the following observation:

> **"Recently, the view that inequality is growth-enhancing has been further challenged by a number of empirical studies, often based on cross-country regressions of GDP growth on income inequality. They all find a negative correlation between the average rate of growth and a number of measures of inequality."[6]**

The survey noted that the results of empirical studies were "impressively unambiguous, since they all suggest that inequality reduces the rate of growth." These studies covered a very broad range of both developed and developing countries from the 1960s through the 1980s, but the empirical evidence for North American and European countries in the 1990s also bears out this general conclusion: the idea of a fundamental trade-off between growth and equality is not warranted.

Section II of this paper surveys the evidence, while Section III explores some positive linkages between relatively low levels of inequality and economic growth. Finally, Section IV takes up the issue of whether "globalization" has broken the possibility of pursuing policies which reconcile efficiency with equity goals.

Table of Contents | Previous Section | Next Section

[Home Page] [E-mail] [Page d'accueil]

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Section II
The Equity/Efficiency Trade-off in Practice: Empirical evidence for North American and European OECD countries in the 1990s

(A) An Overview of GDP Growth and Income Inequality

Table 1 presents data for per capita GDP growth in the 1990s and for household after-tax income inequality (adjusted for household size) in 1995 for Canada, the U.S., Australia and nine European countries. The income inequality (Gini) data are from the Luxembourg Income Study database, and they dictate the size of the total sample of OECD countries. (The Gini co-efficient is the most widely used statistical measure of inequality.) Chart 1 presents the data in such a way as to indicate the relationship between the two variables.

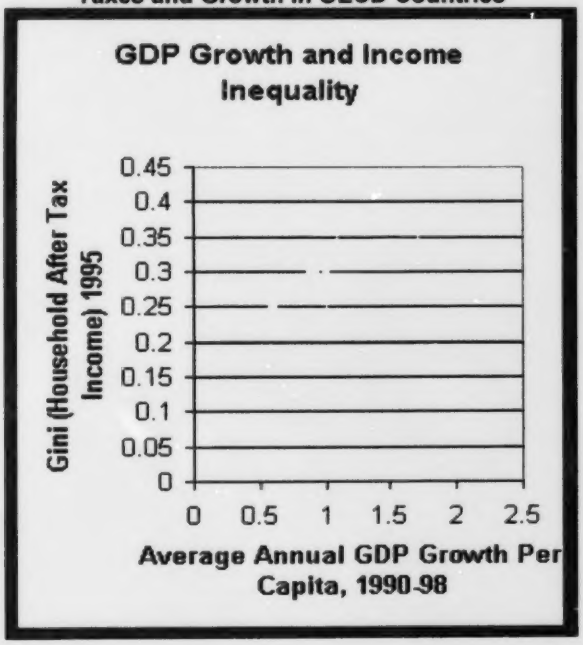
Table 1:
Growth and Income Inequality

	Average Annual Growth of GDP per capita 1990-1998	After-tax Gini 1995
Australia	2.2	0.3378
Belgium	1.5	0.3207
Canada	1.0	0.3019
Denmark	2.3	0.2648
Finland	1.0	0.2429
France	1.0	0.2623
Germany	0.9	0.3069

Italy	1.1	0.3417
Netherlands	2.1	0.2882
Spain	1.9	0.3167
Sweden	0.6	0.2530
United Kingdom	1.7	0.3430
United States	1.7	0.3837

Source: Growth data are from the report of the OECD Statistical Working Party, *Economic Growth in the OECD Area: Are the Disparities Growing*? (OECD, November 1999). American and Canadian GDP data have since been revised, but this is still the most reliable source of comparative data, since GDP data for other countries have not been revised on the same basis. It should be acknowledged that the U.S. has turned in a very good growth performance in the second half of the 1990s.The Gini data are from Lars Osberg and Andrew Sharpe, *International Comparisons of Trends in Economic Well-Being* (Centre for the Study of Living Standards, January 2000).

Chart 1
Taxes and Growth in OECD Countries



The key point that emerges from this comparison is that relatively low income inequality – Gini less than .300 – is associated with either low or high growth. Two low inequality countries – the Netherlands and Denmark – did very well in terms of per capita growth in the 1990s (2.1% and 2.3%, respectively) and indeed, growth in these countries over the period was **more rapid** than in the U.S. or the UK, the two countries with the highest levels of after-tax income inequality. **There was no statistically significant relationship**

between growth and income inequality in the 1990s.

Nor was there a consistent or significant relationship between per capita GDP growth in the 1990s and the change in inequality between 1990 and 1997, as measured by the change in the Gini (data provided below in Table 9). It is notable that there was, in fact, a negligible increase in after-tax income inequality in Denmark and the Netherlands in the 1990s, while the increase in inequality by this measure was much greater in the U.S. than it was elsewhere. Thus, relatively high growth was associated with markedly divergent trends in terms of the change in the income distribution.

The statistically insignificant relationship between growth and inequality, and between growth and changes in inequality, is not surprising, given that GDP growth can be associated with very different patterns of employment performance, and given the wide variations in initial conditions among the countries, not least of which is the

nature of the tax/transfer system, the fiscal position of governments, wage structures, and so on. Some of these differences are explored below.

The conclusion to be drawn is that it has clearly been possible in the 1990s for relatively equal societies to achieve relatively strong rates of economic growth, and to do so without increasing inequality.

(B) Taxes and Growth

The tax share of GDP is a key indicator of the combined size of a country's redistributive tax/transfer system and the extent of access to (equality enhancing) non-market services.

Table 2 provides data on per capita GDP growth and productivity growth as well as data on the total tax burden for an almost complete sample of OECD countries in the 1990s. **There was no statistically significant relationship between the tax "burden" and either economic growth or productivity growth**. Per capita GDP growth has been higher in the U.S. than in most major European countries in the 1990s, but a number of high-tax countries (such as Denmark and the Netherlands) have grown as fast as, or faster than, the U.S., despite – or even because of – a higher tax burden. Many countries with high tax burdens have had strong productivity performance.

Table 2
Taxes and Economic Performance

	Growth of GDP per capita 1990 to 1998	Taxes as % GDP 1994	Growth of GDP per Hour Worked 1990 to 1998
Australia	2.2	28.7	2.3
Austria	1.5	43.3	1.8
Belgium	1.5	45.9	2.4
Canada	1.0	35.1	1.2
Denmark	2.3	49.9	2.1
Finland	1.0	46.7	3.0

France	1.0	43.7	1.5
Germany	0.9	38.4	2.9
Greece	1.2	31.7	1.3
Iceland	1.1	30.9	na
Ireland	5.5	35.7	4.2
Italy	1.1	41.4	1.9
Japan	1.0	27.8	1.9
Netherlands	2.1	44.7	1.3
New Zealand	0.6	36.7	0.2
Norway	3.2	41.3	2.7
Portugal	2.2	32.6	3.2
Spain	1.9	35.0	1.8
Sweden	0.6	49.0	1.9
Switzerland	-0.3	33.0	0.8
United Kingdom	1.7	34.5	2.2
United States	1.7	28.4	1.2

na=not available
Note: Korea, Mexico, Czech Republic, Hungary and Poland are excluded.
Source: OECD Statistical Working Party, *Economic Growth in the OECD Area: Are the Disparities Growing?* November 1999 (DTSI/EAS/IND/SWP(99)3.)

However, there is a strong and significant statistical relationship between the size of the tax "burden" and relatively low income polarization, as indicated by the ratio of the top to the bottom deciles of the income distribution (see data in Table 3). The Spearman's Correlation Coefficient between taxes and the decile ratio is –0.818, significant at the 0.01 level.

The decile ratio (the ratio of the after-tax incomes of the top 10% of households compared to the bottom 10%) clearly indicates continuing and very large differences in the income distribution among advanced industrialized countries in North America and Europe. The ratio varies from a minimum of more than 6 in the U.S., to 4 in Canada, to 3 or less in the Benelux and Scandinavian countries.

Table 3
Taxes and Inequality

	Taxes**	Decile Ratio***
United States	28.4	6.44
Japan	27.8	4.17
Germany	38.4	3.84
France	43.7	4.11
Italy	41.4	3.14
UK	34.5	4.56
Canada	35.1	3.93
Belgium	45.9	2.79
Denmark	49.9	2.86
Netherlands	44.7	3.05
Norway	41.3	2.85
Sweden	49.0	2.78

** Taxes as a per cent of GDP in 1994 (OECD).

***The Decile Ratio is the ratio between the top of the bottom decile and the bottom of the top decile, of the household after-tax income distribution and thus slightly understates the gap between the top and the bottom of the income distribution. Luxembourg Income Survey data for the mid-1990s. Data presented by Timothy Smeeding to the 1999 Canadian Economics Association Meetings.

To summarize, the relationship between taxes as a share of GDP and growth and productivity is statistically insignificant, while the relationship to inequality is strong and significant.[7] Seen from this perspective, relatively high taxes represent a social choice in favour of public as opposed to private consumption, and in favour of redistribution through the tax/transfer process, and it *not true* to say that this choice comes at the cost of reduced national income.

Table of Contents | *Previous Section* | *Next Section*

[Home Page] [E-mail] [Page d'accueil]

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Section III
Which Model Works Best?
A comparison of economic and social performance in the 1990s

This section provides an empirical overview of the experiences of different countries and "models" in the 1990s. Using key statistical data, the conditions and experiences of the U.S., Canada, the UK, Germany, the Netherlands, Denmark, and Sweden are compared.

These countries were selected as being broadly representative of three social and economic models. They include the "liberal" model, which is characterized by a relatively small tax/transfer system to redistribute market income; by a relatively small public sector to deliver services on a non-market basis; and by a relatively "deregulated" labour market with low levels of collective bargaining coverage and government regulation of the terms and conditions of employment. The U.S. is the key example of the liberal model, and Canada and the UK share many of the characteristics of this model, increasingly so in the 1990s.

Sweden and Denmark are key examples of the still strong Scandinavian "social democratic" model, which is characterized not just by regulated labour markets and "generous" welfare provision, but also by a very large non-market public services sector. While this model has been tarnished by the poor economic performance of Sweden in the early 1990s, Denmark has been a highly successful economy over the past decade (as has Norway).

Germany is included as the major example of the "social market" model, with high unionization plus a generous welfare state, but with a relatively small public services sector compared to the social democratic model. The Netherlands shares many characteristics with the German social market model, although with a much more elaborated system of national dialogue among businesses, unions and government over social policy and labour market issues. Those who believe in a strong equity/efficiency trade-off typically cast Germany as the main example of "sclerotic" high unemployment European capitalism. The key purpose of the comparison which follows is to show that equity and efficiency do not necessarily work in opposite directions.

(A) Economic Success and Failure: GDP and productivity growth in the 1990s

As was indicated above and shown further in Table 4, GDP growth per capita was very strong in the Netherlands and Denmark in the 1990s. The U.S. and UK have also done well.

In contrast to the Netherlands and Denmark and the U.S. and the UK, Germany and Sweden have performed badly in growth terms, but they have performed relatively well in productivity terms, even outperforming the U.S. In terms of productivity performance in manufacturing, the Netherlands and Sweden did better than the U.S., with Germany about matching U.S.

performance. The U.S. does stand out as having the highest rate of increase of business investment, but this is partly accounted for by very high rates of U.S. investment in the computer sector which boosts the rate for technical reasons. More recent data do suggest a strong pick up in U.S. productivity growth since mid-decade, but there is not a large U.S.-European productivity growth gap. It should not be forgotten that U.S. productivity growth lagged behind supposedly "sclerotic" Europe through much of the 1980s and 1990s.

Table 4
Economic Performance

	U.S.	Canada	UK	Germany	Netherlands	Denmark	Sweden
Average annual growth of GDP per capital 1990-1998[1]	1.7	1.0	1.7	0.9	2.1	2.3	0.6
Average annual growth of productivity (GDP/hour worked 1990-98[1]	1.2	1.2	2.2	2.9	1.3	2.1	1.9
Average annual growth of productivity in manufacturing 1990-98[1]	3.3	2.0	2.2	3.2	3.8	NA	4.6
Average annual increase in real gross private non-residential fixed capital formation 1990-98[2]	6.6	4.1	3.5	2.3	3.2	4.9	1.6

[1]Data from Table 2 and the U.S. Bureau of Labor Statistics
[2]OECD, *Economic Outlook*, December 1999, Annex Table 6

(B) Labour Market Success and Failure

As noted, a well-functioning labour market is critically important in achieving high levels of income equality. A high level of employment sustains the direct provision of market income to households, thereby reducing dependence on government transfers to the unemployed and underemployed, and thus countering social exclusion and marginalization while freeing up resources for social programs and public services. It is possible for countries with high unemployment to maintain relatively equal income outcomes – as was the case for many European countries through the 1990s – but political support for large and ongoing income redistribution from the employed to the unemployed is quite likely to erode over time.

The health of the labour market in terms of sustaining job growth and reducing unemployment is, of course, closely tied to GDP growth, although productivity growth is a key intervening variable. Countries with high productivity growth (such as Germany) will generate fewer jobs for a given amount of economic growth. Strong GDP growth and strong productivity growth are both needed to obtain a reasonable combination of job growth and growth in household income through higher wages.

The unemployment rate is a widely used and important indicator of the extent to which the labour market is working well, but it is very imperfect. It excludes "discouraged" workers such as the long-term unemployed and those working short hours involuntarily. In many European countries, including the Netherlands, Denmark and Germany, many older (mainly male) workers were given relatively generous early retirement and extended unemployment benefits in the 1980s and early 1990s, and they have since given up actively looking for work. From one perspective, this can be seen as social exclusion; from another perspective, as generous compensation via a decent retirement for the victims of industrial and economic restructuring. In any case, the expansion of such schemes generally came to a halt in the 1990s, and falling unemployment in the Netherlands and Denmark over the decade has not been the result of rising "hidden" unemployment. And the relative success in employment terms of the Netherlands and Denmark in the 1990s was not achieved by squeezing out more jobs from a low rate of economic growth.

Table 5
Employment and Unemployment

	U.S.	Canada	UK	Germany	Netherlands	Denmark	Sweden
Employment/ Population Ratio 1998	73.8	69.0	71.2	64.1	69.8	75.3	71.5
Change 1990 to 1998	+1.6	-0.5	-1.2	-0.6	+9.0	+3.1*	-1.2*
Employment/ Population Ratio Women 1998	67.4	63.3	64.2	55.6	59.4	70.2	69.4
Unemployment Rate – 1998	4.5	8.3	6.3	9.4	4.0	5.1	8.2
Change 1990 to 1998	-1.1	+0.1	-0.8	NA	-2.2	-2.6	+6.4

*Since 1994, start of new series
Source: OECD, *Employment Outlook*, 1999, Tables A and B.

As shown in Table 5, the unemployment rate in the U.S. fell in the 1990s to its current low level of less than 5% – unseen since the "Golden Age" of the 1950s and 1960s – and employment growth has been strong. The unemployment rate in the UK also fell to levels very low by the standards of the 1980s and early 1990s. But here as in Canada, the employment rate has been falling, indicating that declining unemployment has come in part from labour force withdrawal.

Meanwhile, unemployment rates in Germany and Sweden have remained high and employment rates have fallen, along with those of other continental European countries such as France, Italy and Spain. This reality is captured in the common contrast drawn between the booming and dynamic U.S. "new economy" and "sclerotic," high unemployment Europe. The difference is also routinely captured in the contrast between "flexible" and "rigid" labour markets, with high European unemployment being blamed on rigid wages, tough employment standards and the like.

However, unemployment rates today in the Netherlands and Denmark (and in Austria and Norway) are at U.S. levels, even though these countries are at the polar extreme from the U.S. labour market model, as will be indicated below. Moreover, employment growth in the 1990s has been even **more** rapid in the Netherlands and Denmark than in the U.S., as shown in the table.

While it is true that the unemployment crisis is very serious in many European countries, it is not true that the line between countries with high and low unemployment rates is the same as that which can be drawn between countries with regulated and deregulated labour markets. The Netherlands and Denmark – with quite highly regulated labour markets and quite equal societies as compared to the U.S., the UK and Canada – have performed as well as or better than the U.S. in terms of employment growth and achieving low unemployment, just as they have in terms of economic and productivity growth in the 1990s.

(C) Public Spending

As of the mid-1990s, social differences between and among the advanced industrialized countries of Europe and North America remained very large, despite the supposedly all-powerful homogenizing influences of globalization and technological change.

Government spending as a percentage of GDP – a measure of the combined size of income transfers to households and the extent of delivery of public as opposed to private services – still differs radically. The role of the government in income redistribution and the provision of public as opposed to market services (public consumption) was twice as important in the two Scandinavian countries as it was in the U.S. (almost 60% of GDP vs. 30%) and about half again as large as in Canada and the UK. Government spending has fallen somewhat from the historic high points – often recorded as recently as the early 1990s, as in the case of Denmark – but particularly in the Netherlands, this partly reflects success on the job creation front and reduced spending on income transfers to the unemployed.

As shown in Table 6, the ratio of public to private consumption in Sweden and Denmark is about .50, meaning that about $0.50 is spent on public services (not including transfers) for every $1 spent directly by households – double the ratio in the U.S. and half again as high as in other countries. (The Netherlands, though, has a small public services sector.)

Table 6
State Expenditures and Taxes

	U.S.	Canada	UK	Germany	Netherlands	Denmark	Sweden
Government Spending as % of GDP 1998[1]	30.5	42.6	40.1	47.3	43.5	55.5	56.6
Government Spending as % of GDP 1990[1]	33.6	46.7	41.8	43.8	49.4	56.0	56.4
Ratio of Public/Private Consumption 1997[2]	.24	.36	.32	.33	.24	.48	.53

Average Annual Growth of Real Public Consumption Expenditure 1990-1998[3]	0.9	0.7	1.0	1.5	1.5	2.0	0.5
Average Annual Growth of Real Private Consumption Expenditure 1990-1998[3]	3.0	2.0	2.0	4.2	2.8	2.9	0.6
Tax Receipts as % of GDP 1996[4]	28.5	36.8	36.0	38.1	43.3	52.2	52.0
Tax Receipts as % of GDP 1990[4]	26.7	36.5	36.4	36.7	44.6	48.7	55.6
Highest Rate of Personal Income Tax (%) 1996[4]	46.6	54.1	40.0	55.9	60.0	58.7	59.6
Social Security and Consumption Taxes as % of Tax Revenue 1996[4]	40.7	42.9	52.0	56.0	60.4	35.9	52.?

[1] OECD, *Economic Outlook*, December 1999, Annex Table 28.

[2] Data from Osberg and Sharpe, *International Comparisons of Trends in Economic Well-Being* (www.csls.ca)

[3] OECD, *Economic Outlook*, December 1999, Annex Tables 4 and 2.

[4] OECD, *Revenue Statistics of Member Countries*, 1998.

Real public consumption expenditures – i.e., spending on government services – have continued to grow in all countries in the 1990s, although at rates that suggest falling real per person expenditures in the U.S. and Canada.

The gap between public and private consumption growth has been narrowest in Denmark and Sweden, suggesting only a modest tilt towards market provision in the 1990s rather than a shrinking of the public sector in absolute terms. One in three workers in Denmark are employed in public services, and this ratio has remained constant in the 1990s.[8]

The gap between the "liberal" and "social democratic" poles in terms of public spending appears to have grown, rather than narrowed.

As would be expected, tax receipts as a proportion of GDP closely mirror levels of public

spending. The tax burden has remained fairly steady over the 1990s in most countries, though it has fallen modestly in the relatively high tax countries (the Netherlands and Sweden), as well as in the UK. (Denmark, with a rising tax share, replaced Sweden as the highest tax OECD jurisdiction in 1993.) Note that the U.S. tax share has actually grown in the 1990s. The U.S. tax burden *increased* in the 1990s expansion (from 28.9% of GDP in 1992 to 31.0% in 1999) and personal tax rates were made more progressive by the 1993 reforms which increased the top tax rate from 31% to 39.6%.

Due largely to the cost of servicing the accumulated public debt, current tax burdens in all of these countries are higher now than they were in the mid-1980s and overall, there is no sign of a convergence to low tax levels. (Across the OECD as a whole, the tax burden averaged 37.7% of GDP in 1998, up from 37.0% in 1990 and 35.9% in 1985, and down only slightly from the all-time high of 38.4% in 1994.)

As is widely recognized, progressive taxation of high-income individuals and corporations is most vulnerable to the "downward harmonization" pressures of greater economic integration. This has led many conservative economists and the OECD to prescribe shifting the tax base to flat, or regressive, social security and consumption taxes which are borne mainly by working households. High-spending jurisdictions tend to rely more on these "immobile" tax bases, as seen in the data in Table 6, but Denmark is notable for its high reliance on personal income taxes. Top personal income tax rates, as shown, remain highest in the high-tax countries.

(D) The Structure of Labour Markets: Regulation vs. Deregulation

Collective bargaining coverage remains very high in the four non-Anglo Saxon countries at 70% to 90% of all paid workers, compared to less than 20% in the U.S. and about one in three workers in Canada (see Table 7). Moreover, coverage in the former group has not declined in the 1990s, and collective bargaining remains the dominant mode of setting wages, benefits, hours, and working conditions. This is generally done through industry-level bargaining, loosely co-ordinated at the national level, with a lot of flexibility at the enterprise level.

In Germany and the Netherlands, trade union membership is much lower than bargaining coverage, reflecting the formal and informal extension of collective agreements to non-union workplaces, and the non-compulsory nature of union membership. But the fact remains that the unions negotiate the contracts with employers, and individual employment contracts are very much the exception rather than the rule. Trade union membership as such has increased in the 1990s in Denmark, Sweden and the Netherlands.

Generally speaking, employment standards such as minimum wages and the regulation of hours of work follow the same pattern, although this is hard to capture in indicators, and countries differ in the extent to which bargaining and standards mesh together. In many European countries, including the Netherlands, it is common to legally extend the terms of collective agreements to cover all employers and workers in a particular sector.

Table 7

Collective Bargaining Coverage (% of paid workers in 1994)[1]

	U.S.	Canada	UK	Germany	Netherlands	Denmark	Sweden
Collective Bargaining Coverage	18	36	47	92	81	69	89

Trade Union Membership	NA	NA	34	29	26	76	91
Gross Unemployment Benefits Earnings Replacement Rate (mid-1990s)[2]							
Single Earner/First Year	28	49	19	34	70	66	72
Average*	14	30	19	26	47	66	28

[1] OECD, *Employment Outlook*, 1997, Table 3.3.

[2] OECD, *Benefit Systems and Work Incentives*, 1999, Table 3.10.

*Average is for three family types, three durations of unemployment and two earnings levels.

(E) Labour Market Institutions and Equity Outcomes

Labour economists have shown that collective bargaining tends to raise the wage floor and to reduce wage and salary differentials among covered workers, implying that overall wage and market income inequality will be strongly reduced if the rate of bargaining coverage is high. Recent OECD analysis has confirmed a robust statistical relationship between high levels of collective bargaining coverage and/or high legislated employment standards and relatively low levels of inequality in terms of the distribution of earnings and the overall incidence of low pay.[9]

The data in Table 8 show that the dispersion of earnings around the median wage – the wage at the exact midpoint of the earnings distribution – is far wider in the U.S. than in the continental European countries. (To the fullest extent possible, the data control for hours worked.) In the U.S., men in the top decile of the wage distribution earn at least twice the median wage, compared to a ratio of about 1.6 in the continental European countries, and the gap between the bottom decile and the median is larger again in the U.S.

As a result, men in the top decile earn a minimum 4.3 times more than those in the bottom decile in the U.S., 3.8 times more in Canada, and 3.4 times more in the UK, compared to a ratio of only 2.2 in Germany and 2.1 in Sweden. These differences are very large indeed. Moreover, they have been growing somewhat in the 1990s only because of increasing inequality in the "liberal" labour markets, the U.S. and the UK. **There has been no significant increase in wage inequality in the continental European countries in the 1990s, as indicated by the illustrative D9/D5 ratio for men shown in the table.** (See OECD data for further confirmation)

Table 8
Wage Dispersion

Earnings Dispersion (mid-1990s)[1]	**U.S.**	**Canada**	**UK**	**Germany**	**Netherlands**	**Denmark**	**Sweden**
Men							
D9/D5	2.04	1.73	1.86	1.64	1.66*	1.57*	1.62

D5/D1	2.13	2.18	1.78	1.37	1.56*	1.38*	1.36
D9/D1	4.3	3.8	3.4	2.2	2.6*	2.2*	2.1
Women							
D9/D5	2.03	1.78	1.68	1.59	1.66*	1.57*	1.40
D5/D1	1.95	2.25	1.87	1.42	1.56*	1.38*	1.30
Men (1985)							
D9/D5	1.84	1.68	1.71	1.66	1.64*	1.54*	1.58
Incidence of Low Paid Employment (mid-1990s)[2]**							
Total	25.0	23.7	19.6	13.3	11.9	-	5.2
Men	19.6	16.1	12.8	7.6	-	-	3.0
Women	32.5	34.3	31.2	25.4	-	-	8.4

[1]OECD, *Employment Outlook*, 1996, Table 3.1. (Data are for weekly or hourly earnings and thus largely account for differences in hours worked.) D9 is the top of the 9th decile, i.e. 10% earn more; D5 is the top of the 5th decile, i.e. median earnings; D1 is the top of the 1st decile, i.e. 10% earn less.
[2]OECD, *Employment Outlook*, 1996, Table 3.2.
*Men and Women: No gender breakdown is available.
**Less than 2/3 median earnings of all workers.

Table 8 also shows the incidence of low paid employment in the mid-1990s, defined as employment in a job paying less than two-thirds the economy-wide median wage. As shown, low wage employment by this definition is much lower in Sweden and, to a lesser degree, in the Netherlands and Germany than in the "liberal" labour markets. Again, the differences are profound with about 1 in 4 workers – and 1 in 3 women – working in low wage jobs in North America, compared to only 1 in 8 in Germany and the Netherlands, and just 1 in 20 in Sweden.

The existence of wage floors and the wage compression which results from collective bargaining have been very significant in promoting greater equality between women and men in the labour market and in the wider society.[10] In "liberal" labour markets (the U.S., Canada, the UK), employment rates for women are high, but beyond (limited) public services, women are disproportionately employed in low wage, non-union jobs in smaller firms in private services. In some European countries, employment rates in

public services tend to be higher and, most importantly, the quality of jobs in the small firm, private services sector is directly raised by labour market regulation.

(F) Household Income Inequality and Poverty

A relatively equal distribution of wage income will obviously tend to produce a relatively equal distribution of household income in a high employment/ low unemployment economy, or in societies where there is relatively generous compensation for unemployment compared to average wages. As shown in Table 9 and was noted above, the overall distribution of household disposable

income (post-tax and social transfer income) is vastly more unequal in the U.S. and, to a lesser extent, in the UK than in the Netherlands, Denmark and Sweden. In the U.S., the top 10% of households (equalized for household size) have disposable incomes at least 6.44 times higher than the bottom 10%, compared to a ratio of 4 for Canada and Germany, and 3 or less in the Netherlands, Denmark and Sweden. The Gini shows a similarly wide variation between the two model extremes.

Income inequalities by these measures have increased somewhat from the 1980s to the 1990s. However, as shown in the table, different patterns exist. Income after-tax inequality has steadily increased in the U.S. and, to a lesser extent, in the UK over the past 20 years – despite falling unemployment in the 1990s. In the other countries, the increase in inequality came – if it came at all – in the 1980s and has not continued into the 1990s. Strikingly, there has been no significant increase in after-tax income inequality in the Netherlands and Denmark in the 1980s or 1990s, although there was in Sweden and Germany in the 1980s.

Table 9
Income Inequality and Poverty

	U.S.	Canada	UK	W. Germany	Netherlands	Denmark	Sweden
Household income inequality (Gini)[1]	.3837	.3019	.3430	.3069	.2882	.2648	.2530
Change in Gini Co-efficient of after-tax income[1]							
1980	100	100	100	100	100	100	100
1990	107	96	114	136	99	96	117
1997	117	95	118	119	101	93	118
Polarization: Decile Ratio[2]	6.44	3.93	4.56	3.84	3.05	2.86	2.78
Child Poverty Rate[2] (living in household with less than half median income)	22.7	13.9	17.9	8.7	4.1	4.0	2.7

Elderly Poverty Rate[2] (less than half median income)	23.7	4.8	12.8	7.9	2.6	5.6	6.0

[1]Lars Osberg and Andrew Sharpe, *International Comparisons of Trends in Economic Well-Being* (www.ccsls.ca)

[2]Luxemburg Income Study data for mid-1990s, presented by Smeeding to meetings of the Canadian Economic Association, 1999. Data are for after-tax/transfer (disposable) income of all individuals, adjustedfor household size. The decile ratio is between the bottom of the top decile and the top of the bottom decile.

At the end of the millennium, there were profound differences in terms of the equality of household income distribution between and among advanced industrialized countries and few signs of convergence to the liberal model. (Canada is an important exception: by the end of the 1990s, there were signs that the long-standing stability of after-income shares may have come to an end because of developments in the labour market and cuts to Social Assistance and Employment Insurance.)

The injuries of high income inequality under the "liberal" model are, of course, also compounded by the relative lack of access to low-cost public services. In these societies, low disposable income is not complemented by high levels of access to services based on rights of social citizenship. Similarly, the relatively low levels of disposable income inequality in the continental European countries are further mitigated by equality of access to many services.

As also shown in Table 9, the child poverty rate – defined as living in a family with income below 50% of median income – is very low in the Netherlands, Denmark and Sweden, with just 1 in 25 children or less living in poverty, compared to 1 in 7 children in Canada and almost 1 in 4 children in the U.S. The depth of child poverty is also much greater in the high-poverty countries. A recent report from UNICEF clearly links the national level of child poverty in rich countries – both in relative terms and in absolute terms – to both the incidence of low wages and the level of social expenditures.[11]

The CCSD's *Canadian Fact Book on Poverty 2000* documents the particularly important role of transfers in reducing poverty among all family types. The elderly poverty rate (defined on the same basis as less than 50% of median income) shows a similar pattern, although Canada has done as well here as the most advanced welfare states.

(G) Money, Time and the Labour Market

International comparisons of income as a measure of comparative well-being usually fail to adjust not only for income inequality, but also for time worked. GDP per person is a function of productivity (GDP per hour worked) and total hours worked, which will be higher in high employment economies, and where the regular hours of work are high.

Table 10 presents data for GDP per hour worked for our sample of countries, indicating that the productivity gap between the U.S. and other countries is generally much narrower than the income gap. Indeed, workers in Germany and the Netherlands are just as productive as workers in the U.S., so differences in GDP per capita are entirely a function of total hours worked.

Table 10
Income and Productivity

	U.S.	Canada	UK	W. Germany	Netherlands	Denmark	Sweden
GDP per capita at PPP as % U.S. level	100	81	70	75	76	87	70
GDP per hour worked at PPP as % U.S. level	100	85	84	100	101	85	79

Source: OECD Statistical Working Party, *Economic Growth in the OECD Area. Are the Disparities Growing?* November 1999, Table 2.7, Table 2.

This partly reflects the split between full- and part-time work. As shown in Table 11, the part-time employment rate among women is relatively low in the U.S. and very high in the European countries outside of Scandinavia, particularly the Netherlands. Not all part-time employment is voluntary, and part-time jobs can represent hidden unemployment, as in Canada, where about 1 in 3 women working part-time say that they would prefer full-time work. Further, the "choice" of part-time work is heavily overlaid by traditional family roles, lack of access to child and elder-care services, and discrimination and exclusion of women from good jobs. That said, part-time work is what most women part-timers seek in the labour markets of most countries. High rates of part-time work are thus an ambiguous indicator of relative labour market success or failure.

Arguably, the Netherlands has been highly successful in creating the part-time jobs wanted by women, and it must be underlined that the pay, benefits and other conditions of part-time work are much more comparable to those of full-time workers than in more deregulated labour markets, and the hours tend to be more regular. Generally, equal pay and access to benefits are legally mandated or set out in collective agreements in the regulated labour markets, so the incidence of low-wage work, as noted above, is relatively low.

Table 11
Working Time

	U.S.	Canada	UK	Germany	Netherlands	Denmark	Sweden
Average hours worked per person in employment[1]							
1998	1957	1777	1737	1580	1365	NA	1551
1990	1943	1790	1767	1625	1433	NA	1480

Proportion of men working long hours[2] (45+ per week)	26	22	42	8	2	15	17
Incidence of part-time employment for women[3]	19.1	28.6	41.2	32.4	54.8	25.4	22.0

[1]OECD, *Employment Outlook*, 1999, Table F
[2]OECD, *Employment Outlook*, 1998, Chart 5.2.
[3]OECD, *Employment Outlook*, 1999, Table E

Historically, the reduction of regular hours of work has been considered to be a major aspect of social progress. In the "Golden Age" of the 1950s to the mid-1970s, work hours generally fell across countries, although vacation entitlements tended to be significantly higher in Europe. In the 1980s, Europe saw a steeper fall in the usual age of retirement than in North America. Workers in many continental European countries tried to win shorter hours in the 1990s through collective bargaining and legislation, with particular emphasis on this goal in Germany, the Netherlands and Denmark.

In Denmark, an initiative in the mid-1990s to reduce work hours took the novel form of allowing employed workers to take training and sabbatical leaves financed from UI benefits, in order to open up available jobs. At its peak, almost 2% of the workforce took up this option.

Reductions of work hours have been sought not only to save and create jobs, but also for their own sake. As shown in Table 11, the proportion of men working long hours is very low in the Netherlands and Germany (where the working week "norm" is now down to no more than 35 hours) and it is very high in the UK and the U.S., where more than one in 4 men work more than 45 hours per week. Moreover, the number of hours worked per year per person employed – a function of the rate of part-time work and of

hours in full-time jobs – vary enormously, with an average worker in the Netherlands putting in only seven days for every 10 days worked by an American worker. As shown, average annual hours worked have moved significantly lower in the Netherlands and Germany in the 1990s. Annual hours worked likely fell in Denmark taking into account the effects of the leave scheme. Further, in early 2000, Danish workers won an increased week of paid vacation, bringing the total to six weeks per year.

Total hours worked per year are high in the U.S. because of a low unemployment/high employment rate, a relatively low incidence of part-time employment, and a high incidence of very long hours among full-time workers. If shorter work time is judged to be an indicator of social progress, then Germany, the Netherlands and Denmark have done very well in the 1990s.

(H) A Summary of Economic and Social Progress in the 1990s

To summarize, in the 1990s, in Denmark and the Netherlands at least, economic success in terms of GDP and productivity growth was combined with labour market success in terms of job creation and low unemployment. These countries were also quite successful in equity terms, with the distribution of wages and after-tax income being markedly more equal than in the "liberal" countries and staying that way. The hours of work were reduced in a positive way, through reductions of regular working time rather than through involuntary unemployment and

underemployment.

In the other European countries, there was a more mixed picture and there is no denying that economic success as measured by job creation and reduction of very high rates of unemployment eluded Germany and Sweden in the 1990s, as well as France and other larger European countries. In terms of indicators of equity – social spending, distribution of wage and after-tax income – the evidence suggests that European countries other than the UK have become more, rather than less, distant from the liberal model. In equity terms, the distance between countries has grown due more to increased inequity in "liberal" countries than because of convergence to the liberal model. The U.S. can be seen as an economic success, but as a failure in terms of equity.

Table of Contents | *Previous Section* | *Next Section*

[Home Page] [E-mail] [Page d'accueil]

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Why We Don't Have to Choose between Social Justice and Economic Growth:

The myth of the equity/efficiency trade-off

Section IV: Causes of Success and Failure

The purpose of this section is to review some general issues which bear upon the question of relative economic performance. It is argued that macro-economic factors explain much of the differential in growth performance between countries (as opposed to social and labour market policies) and that high taxes and "generous" welfare states are, at a minimum, consistent with relatively good economic performance for two key reasons. First, the choice between delivery of services through the public sector as opposed to the market is largely neutral in terms of efficiency. Second, the so-called dead weight or efficiency costs of relatively high and progressive taxes tend to be greatly exaggerated.

Finally, this section briefly reviews some general grounds for believing that there may be a positive linkage between low levels of inequality and economic growth, and it reviews some of the evidence linking the economic performance of the Netherlands and Denmark to underlying social factors.

(A) Macro-economic Factors

The generally dismal employment experience of much of Europe and Canada in the 1990s, when compared to the U.S., has frequently been blamed on more regulated labour markets and more generous welfare states. Without long elaboration here, it should be noted, however, that much of the difference in growth performance can be attributed instead to the policy decision of most central banks to place a strong emphasis on achieving very low rates of inflation through continuing high real interest rates. U.S. economic growth through the 1990s has been underpinned by much more expansionary monetary policy.

While the U.S. Federal Reserve was certainly concerned with the possibility of inflation as the 1990s recovery continued, they allowed the unemployment rate to fall far below the "NAIRU" level which had once been considered to be inflationary, and they tested the potential for non-inflationary growth before gently applying the monetary brakes. To a significant extent, Europe "chose" low inflation over the reduction of unemployment by maintaining high interest rates in the 1990s even in the face of stubbornly high unemployment. This policy was also bound up with the process of European Monetary Union.[12]

Following broadly comparable performances in the 1980s, the significant Canada-U.S. growth differential which emerged in the 1990s also owes much to macro-economic policies. The OECD and the Department of Finance largely agree that Canada's much tighter monetary policy at the start of the decade produced a deeper and more prolonged downturn than in the U.S., and was the major cause of the more serious Canadian debt/deficit problem. This, in turn, resulted in much more contractionary fiscal policies in Canada through much of the 1990s.

While Denmark and the Netherlands generally pursued monetary polices comparable to other European countries, one difference lies in the fact that both had largely eliminated their large public sector deficits in the 1980s, and they were not obliged to make deep cuts to public spending in the 1990s. Indeed, Denmark significantly boosted spending early in the decade to help lower unemployment. In short, macro-economic policy continues to make a significant difference.

(B) The Efficiency Neutrality of the Choice between Private and Public Consumption

While it is often argued that the high tax "burdens" needed to finance income redistribution and high levels of public and social services reduce growth, the evidence above and a large and growing literature suggest that the social decision to maintain or not maintain a relatively large public sector is, in fact, neutral or even positive.

There are plausible and well-documented links between high levels of public spending on broadly accessible health and education programs and workforce productivity, and there is every reason to believe that the market provision of education, skills training and health result in costly and inefficient delivery of services and the exclusion of many. There is no good reason to believe that paying for health, education, pensions and day care through taxes rather than through market income, and delivering services through the public rather than the private sector, carries a cost in terms of economic efficiency. Indeed, private systems of delivery – such as U.S. health care – are widely considered to be cost inefficient as well as socially unjust.

To illustrate, a recent study by Allan Larsson – a senior official with the EU Employment and Social Affairs Directorate – noted that about 40% of household expenditures in both the U.S. and Sweden goes to social protection – health, education, pensions, and day care combined (41.2% in Sweden vs 39.6% in the U.S.). The difference is that, in Sweden, 90% of that expenditure is financed through taxes and almost none from after-tax income, compared to just 25% from taxes in the U.S. As he noted, the choice is not between high and low overall costs for social protection, but rather between a more or less equal distribution of income, services and opportunities.[13]

Canada's more redistributive tax/transfer system compared to the U.S. is also complemented by a higher level of delivery of public services, replacing some expenditures from after-tax income. In the U.S., medical care expenses consume a startling 13.96% of after-tax household income, compared to just 3.2% in Canada, while a recent OECD study found that private U.S. household spending on social security – contributions to private pensions, health, disability, and similar plans – amounts to more than 8% of U.S. GDP – well above the 1% to 3% range in continental European countries [14]

To the extent that higher taxes simply represent a choice to finance social security and some services from taxes rather than from after-tax income, the "burden" is simply a reallocation of funds from private to public consumption.

(C) Taxes, Equity and Efficiency

Much of the case for an equity/efficiency trade-off rests on the view that high taxes – and particularly progressive income taxes – reduce incentives to work and to save and thus reduce growth. This argument rests on the core "free market" proposition that taxes "distort" market signals, and that efficiency losses will therefore rise in line with the general tax level as a proportion of GDP, particularly if the tax burden is heavily tilted towards the most "distortionary" forms of tax. Most current advocates of tax cuts argue that a lower level of taxation will boost longer term economic growth by creating a more competitive, dynamic and efficient economy (This section of the paper summarizes part of the argument put forward by Andrew Jackson in "Tax Cuts: The Implications for Equity and Efficiency," in the *Canadian Tax Journal*, Vol. 48, No. 2, 2000.)

Current economic research provides, at best, very thin and mixed support for the large efficiency impacts commonly expected from general tax reductions. With respect to the taxation of labour income – via personal income taxes and social security contributions which create a "tax wedge" between the total wage costs of the employer and the take-home pay of workers – one theoretical argument is that higher average and marginal rates will reduce the willingness of workers to supply more labour. Thus, higher taxes will allegedly result in workers being less prepared to work long hours or work overtime, or even to invest in the skills needed to get higher paying jobs. Conversely, however, it can be argued that higher average and marginal tax rates on labour income will actually *increase* the willingness of workers to work longer hours, since they need to work those additional hours to get the same or more after-tax income.

With respect to the taxation of capital income, the basic theoretical argument is that increased taxation of property income in the hands of individuals (through dividends, capital gains, interest, and so on) will lead people to save less. Again, however, it can just as plausibly be argued that lower after-tax returns from savings will lead people to save *more* in order to reach the same savings target.

As summarized by the OECD in a major 1997 survey of the literature, when it comes to the taxation of labour income, national and comparative cross-national research shows that there is little or no impact from higher taxes on the willingness to work of (predominantly male) primary income earners.[15] Similarly, an IMF survey of the literature found that "although studies do not all agree on whether the uncompensated wage elasticity of men is positive or negative (i.e., on whether men increase or decrease their hours worked in response to an increase in their wages), the majority of studies agree that whatever the sign of the elasticity, its absolute value is small."[16]

Recent studies show that past differences between men and women have fast eroded, and that work effort is very insensitive to after-tax income.

It has also been argued that a progressive income tax rate structure creates disincentives to workers taking higher paying but more stressful jobs, or upgrading their education and skills. However, the idea that workers avoid high paying jobs in order to avoid high taxes is implausible, and studies tend to show that very few jobs, even high-skill jobs, are left unfilled because of a lack of qualified applicants. Only one percentage point of the Canadian unemployment rate in 1999 was due to skill shortages.[17]

The final alleged link between personal taxes and economic growth is through personal savings. As noted above, it can theoretically be argued that taxes on capital income reduce or alternatively, increase personal savings. Economists have been unable to show that after-tax returns affect savings rates, either positively or negatively. Overall, the

OECD concludes that "on balance, it appears that taxing capital income reduces savings, but not by very much." They note that, based on one recent study, the complete elimination of the average tax rate of 40% on capital in 21 OECD countries would raise private savings by about 0.5% of GDP.

It is notable that the U.S. – clearly a low-tax jurisdiction compared to most OECD countries – has consistently had one of the lowest personal savings rates in the OECD. By contrast, personal savings rates are very high in many European countries that have high levels of personal taxation as a share of GDP. National savings rates vary more because of institutional features – such as the nature of pension arrangements and the nature of housing markets – than as a result of differences in tax systems. The key conclusion is that there is no strong evidence for the argument that cutting taxes on property income will lead to higher savings rates.

In the case of Canada, a major link from high and progressive personal taxes to growth has been via an alleged "brain drain" to the U.S. However, Canada attracts many more skilled and highly educated workers than it loses and in the 1990s, the outflow to the U.S. has been very modest – and indeed, at an historic low point. It is far from clear that taxes play the major role in decisions to emigrate.

Another key theoretical link from taxation to growth is the channel from the cost of capital (which is influenced by business taxes) to business investment (that is, investment in structures, machinery and equipment, as well as "soft" business investment in research and development and in worker skills). Economists agree that high levels of business investment contribute to faster labour productivity growth by increasing the capital stock, and business investment in research and development, innovation and skills is a vitally important source of growth in a "knowledge-based economy."

In mainstream economic theory, the cost of capital – which is influenced by the level and structure of corporate income and capital taxes – has a direct impact on the level of real business investment. If the "capital tax wedge" or marginal effective tax rate on investment rises, then investment will fall. (The tax system may also shift the composition of investment by favouring or discriminating against certain sectors.) A negative impact on investment from the effect of taxes on the cost of capital is certainly theoretically plausible, but as the IMF study reports, "numerous studies...have attempted to measure the influence of the cost of capital on investment. While many of these studies find that investment is negatively related to the cost of capital, most find that the size of the effect is rather small."

The OECD survey of the literature also found that "while many studies find that investment is negatively related to the costs of capital, most find that the effect is small." Economists have found that business investment is much more strongly related to the growth of the market (the demand side) than to the cost of capital (the supply side), since firms will not invest – even if taxes are low – unless markets are expanding.

The major point is that macro-economic policy – the level of real interest rates, fiscal policy – is by far the most important variable behind the level of real business investment.

To be sure, corporate tax rates play a role in where companies invest, and there have been recent trends towards a downward harmonization of corporate taxes across countries. But an investment may promise a high rate of return for many reasons: access to skilled workers, high productivity, access to good public infrastructure, access to energy, resources and other inputs at favourable prices, and so on. In the case of Canada, a 1999 benchmark study by KPMG, *The Competitive Alternatives,*[18] finds that the effective total tax rate for nine industries is slightly lower than in the U.S. (35.7% vs 36.0%), while Canada has a significant cost advantage in numerous non-tax areas. The

small difference in effective corporate income tax was more than offset by other, lower taxes.

To summarize, the mainstream economic literature as summarized by the IMF and the OECD does not support the frequently heard argument that relatively high taxes kill growth and jobs. In an increasingly integrated global environment, there may be some negative influences from very progressive income taxes and high corporate taxes, but there is still a lot of room for choice. As shown above, overall tax levels have not been harmonized downwards, and there is no good reason to believe that a high level of taxes is incompatible with growth, particularly when the importance of public investment in growth is considered.

(D) Positive Linkages from Equality to Growth: Investment in Human and Social Capital

The economic literature on development, such as recent World Development Reports from the World Bank, has begun to draw some positive empirical and theoretical linkages between equality and economic growth, emphasizing such issues as access to credit and basic education for the poor, and the relationship between high inequality and destructive social and political conflict. The fundamental – and not surprising – message is that marginalization of a large part of the population in deep poverty is negative for economic development. While this literature is less relevant to the analysis of the comparative growth performance of OECD countries, it has drawn attention to the potential linkages from income distribution to growth which take place through investment in human and social capital.

A key tenet of the so-called new growth theories is that long-term growth is driven less by investment in physical capital (buildings, machinery and equipment, infrastructure, etc.) than by innovation and the advancement of knowledge and learning which involves high levels of investment in human capital. Osberg notes that "one of the major themes of recent growth theory is the importance of human capital in production and the intergenerational transmission of human capital."[19]

Few would disagree that investment in education and training has a major role to play in growth, and growth in OECD countries has indeed been linked to increasing educational attainment. Hansson and Henrekson find that higher government expenditures on education were positively associated with higher average private sector productivity growth in OECD countries from 1965 to 1982.[20] The literature as a whole, as

reviewed by the IMF, suggests that the returns from public investment in education are high. In Canada, a strong argument has been made by Fraser Mustard and associates at the Canadian Institute for Advanced Research that investments in early childhood education yield large future returns in the form of a better-educated and more skilled workforce.

The links from income inequality to the development of human capital are no less clear than the links from human capital to growth. There is abundant evidence that children from low-income households tend to do less well in school than do their peers.[21] Further, negative linkages from low income and poverty to poor educational achievement compound and continue over time. Low educational attainment will increase inequality among the present generation, which will have an impact on the successor generation and will impact on future growth. The frequently made distinction between equality of opportunity and equality of results makes sense only in a single generation model. Given the importance of conditions in childhood to human development, there has to be some equality of condition in the present in order to generate equality of opportunity for the next generation.

In this context, it is worth noting that the ranking of countries by a common standard in terms of the literacy and numeracy levels of young people and adults – perhaps the most fundamental measure of human capital in a world of very different educational systems – is suggestive of a close link to overall levels of income inequality. Based on the results of the International Adult Literacy Survey (IALS), the high-equality Scandinavian countries rank highest in terms of average literacy scores, followed by Germany and the Netherlands, with Canada and the U.S. lagging behind. The Scandinavian countries rank well in terms of the proportion of adults with high scores, but the major difference is that the incidence of limited literacy levels is very low. Put another way, the low income inequality countries tend to have a very narrow spread of literacy scores. Also, the literacy attainment of young adults is less strongly linked to the socio-economic background of parents than in other countries. In short, there is a direct link from inequality to human capital as measured by literacy, and the IALS report closely documents this link, as well as the positive links from literacy to growth.[22]

These studies also indicate that higher skill production models in Europe are linked to the higher literacy and numeracy levels of production workers.

Most economists recognize that public investment has positive impacts on growth, and the importance of public investment in physical infrastructure, education, training, and research and development is not controversial (even though it is necessarily financed by taxes.) Income redistribution through transfer programs is, however, often seen in a much more negative light, notwithstanding the growing evidence that high inequality is associated with low, rather than high, growth. An interesting recent study has linked higher public spending on transfers (which directly reduce inequality) to economic growth in OECD countries, although the linkages are not explored.[23]

As has been noted, some people have suggested that there is a linkage from relative equality produced by transfers to growth through improved human capital. Others have pointed to reduced social costs such as the costs of crime, urban pathologies, the lost productive potential of the marginalized population, and public expenditure on defensive necessities like police and prisons rather than productive investment. While plausible, research on the linkage of deadweight social costs of income inequality to economic growth is still in its infancy. Research studies have, however, shown very clear linkages from inequality (and not just poverty) to ill health, suggesting that inequality reducing transfers may reduce public and private health costs. Whatever the direction of causality, it is clear that the level of spending on transfers and public services has tended to rise with national income, suggesting either that public expenditures promote growth, or that richer societies tend to choose greater equality and more security outside the market.

Another relatively recent theme is that growth is positively impacted by high levels of social trust and co-operation (social capital).[24] Again, however, the links from co-operation to growth have not been specified very concretely. The next section of this paper attempts to makes sense of some of the cross-country comparisons made above in terms of the level of social co-operation.

(E) Social Co-operation as a Factor in Job Creation and Economic Growth

As previously noted, labour market regulation tends to narrow wage differentials and to raise the relative pay of lower paid workers, thereby reducing the inequality of incomes directly generated by the job market. At issue are the impacts on growth, job creation and productivity. The argument here is that equal outcomes sustain growth through trust and co-operation.

While labour market "rigidities" have been widely attacked as economically inefficient, collective bargaining and employment standards can achieve "efficient" outcomes in terms of balancing wage and productivity growth, facilitating workforce adaptation to changing market conditions, and maintaining the profitability of private investment.

Over the past few years, the annual OECD *Employment Outlook* has provided substantial evidence on this point, implicitly criticizing the influential 1995 OECD *Jobs Study*. For example, the 1997 *Employment Outlook* contained a long study which found no correlation for OECD countries between levels of collective bargaining coverage or trade union density and various measures of economic performance, and the 1996 and 1998 editions of *Employment Outlook* contained comprehensive studies which found no significant links between high wage floors (set by bargaining or minimum wages) and lower rates of employment of less skilled workers. In other words, the equity gains did not carry an employment or economic efficiency price.

There is an abundant literature that documents the positive effects of collective bargaining, union representation and employment standards on productivity at the industrial and firm level. The key links include higher capital investment, reduced worker turnover and thus higher levels of firm-specific skills and higher returns on firm investment in training, and increased workplace co-operation on the basis of negotiated agreements on technology, work organization, working conditions, and other issues. The major study *Paying for Productivity*, by U.S. economist Alan Blinder for the National Bureau of Economic Research, shows that the productivity gains from new technology are crucially dependent upon workplace co-operation and that good industrial relations are key.

The ILO's *World Employment Report* of 1995 (Part 4) contains an extensive rebuttal of the labour market deregulation prescription for growth and job creation, emphasizing the importance of employment stability and negotiated workplace dialogue to "functional flexibility" at the workplace level. The report also recognizes the positive dynamics that arise when unions close low wage routes to firm and industry competitiveness and force the new investment in capital, innovation and skills needed to raise productivity through the production of more innovative and sophisticated products and services.

These positive impacts reflect the reality that bargaining at the firm or national level is about an accommodation of interests. While unions expect that productivity improvements will be shared, wage bargains necessarily reflect the competitive situation facing firms and the need to maintain strong, private investment to achieve future growth.

The alleged disincentive effects of good income security programs for unemployed workers are greatly exaggerated, and "generous" UI benefits have been found to reduce poverty and income inequality and to facilitate efficient job search.[25] Moreover, unions and governments in many countries with "generous" UI systems support active labour policies that emphasize training on the job, rights to training and education leaves, and the retraining and direct creation of good jobs for the unemployed, rather than "passive" long-term income support. (That said, socially compensated long-term unemployment is indeed an unfortunate major feature of many European countries.)

High levels of public investment in labour adjustment and skills training programs have rightly been seen as a key ingredient in the good employment performance of Sweden in its heyday, and more recently, in Denmark and the Netherlands which moved strongly in this direction in the 1990s. Denmark, in particular, has greatly expanded such programs in the 1990s, moving from a German-style "passive" benefits system to a Swedish-style "active" labour market policy designed to counter long-term unemployment. Effectively, young people are guaranteed a subsidized job at normal wages or a training position that leads to real job opportunities.[26]

In the Netherlands, some trimming of long-term unemployment benefits has been accompanied by the expansion of active labour market programs to ensure a successful transition from school to work for young people, resulting in a youth unemployment rate near zero. In the 1990s, the Netherlands also greatly expanded subsidized employment for marginalized groups such as the older long-term unemployed and workers with disabilities who have been placed with both private and public sector employers.[27]

In the Netherlands and Denmark, there has been a conscious shift of policy away from the provision of long-term transfers to the unemployed and towards subsidized job creation, income supports for marginal workers, and training.[28] In both countries, social security reforms affecting unemployment and long-term benefits have been negotiated on a tripartite basis, and the unions are active co-managers of the social security systems. In short, there has been reform in the direction of more active policies, but limited direct cuts to benefits. In the Netherlands and Denmark, particularly the former, most observers agree that collective bargaining has accommodated the growth of part-time work and flexible work hours (such as weekend work and more variable shifts) while preserving a high floor of minimum conditions. Part-timers get the same hourly wages and benefits as full-time workers, and casual "on-call' work is very much the exception. While short-term employment contracts are permitted, there are limits on their duration so that temporary workers can obtain permanent status quite quickly. The social and economic significance of non-standard work is thus quite different in these countries than in the liberal labour markets of the U.S., the UK and Canada, where there are very large gaps in income, benefits and rights between permanent, full-time (i.e., standard) and temporary or part-time (non-standard) workers.

The key point is that regulated labour markets promote more equal wages, benefits and working conditions, but they do not necessarily carry a significant price in terms of labour market rigidity. It is quite possible for the labour market to be flexible to changing conditions without there being large differences in pay. A key conclusion of the ILO studies of employment success in Europe is that a combination of flexibility for employers and security for employees has been achieved. The precise terms of the negotiated arrangements vary, but the key point is that the arrangements have been negotiated, and accommodations made on both sides.

At the macro-economic or society-wide level, national wage pacts and a "new corporatism" have been seen as by the ILO and the European Commission as a major reason for the relative employment and growth success of a number of smaller European countries – Ireland, Denmark, the Netherlands, and Austria. The core argument has been that strong labour market institutions do not necessarily result in a lack of adaptability of national wages to changing macro-economic and competitive conditions or as a barrier to needed flows of labour between industries, and are still important in terms of sustaining demand.

The economic success of some smaller European countries in the 1990s owes much to wage moderation. In the Netherlands, Ireland, Denmark, and Austria, trade unions and employers have consciously bargained so as to maintain the profitability of national firms to increase employment and to win new investment. In the case of the Netherlands and, to a lesser extent, Denmark, reductions in regular working-time were very much a part of the arrangement, and hours reductions played a role in the high rates of job growth. In all of these countries, the maintenance of collective bargaining arrangements and of good employment standards has been implicitly part of the deal, along with the maintenance of reasonably generous welfare states. Wage moderation – though not at the expense of an increase in real wages – has been given in return for job creation and the maintenance of low levels of wage and income inequality.

In the manufacturing sector – for which the data are most consistent and reliable for making international comparisons – it is clear that regulated labour markets have resulted in reasonable growth of wages in relation to productivity.

Table 12 presents data on the average annual rate of increase of unit labour costs in manufacturing, with a positive number indicating that nominal hourly wages have increased at a faster rate than real hourly output. As shown, wages have increased modestly in relation to productivity in the U.S., and the same has been true in the Netherlands, Denmark and Sweden. The growth of unit labour costs has been much more rapid in the UK (where it was offset by a significant currency depreciation when Britain left the ERM) and in Germany.

Table 12
Wages

Labour Cost Competitiveness in Manufacturing (1990-98)	US	Canada	UK	Germany	Netherlands	Denmark	Sweden
Average annual change in unit labour costs [1]	0.2	0.7	2.8	1.3	-0.5	0.2	-0.4
Average annual change in real hourly wage in the business sector [1]	0.4	0.4	0.8	1.8	0.6	NA	0.3
Average annual increase in real wages per employee [2]	0.5	1.0	0.3	1.2	0.3	1.5	1.3

[1] U.S. Bureau of Labor Statistics. Hourly wage deflated by Consumer Price Index.
[2] OECD, *Economic Outlook*, Annex Tables 12,16.

The second column in Table 12 shows hourly wage growth in manufacturing, deflated by the national consumer price index. It is notable that real hourly wage growth in Germany – and to a lesser extent, the UK – has been significantly higher than in the other countries. Similarly, the growth of real wages per employee in the business sector has been significantly higher in Germany than in the U.S., though no higher by this measure than in Denmark or Sweden. (Unfortunately, this measure does not control for hours worked.)

In the U.S., in the manufacturing sector and in the business sector as a whole, productivity growth in the 1990s has been running significantly higher than real wage growth. While there are several reasons why wages deflated by consumer prices might lag behind output growth deflated by producer prices, the evidence shows that the corporate profit share and the corporate profit rate in the U.S. have been strongly rising in the 1990s and that the fruits of growth have gone disproportionately to business profits.

The pre-tax corporate profit rate in the U.S. (returns to capital per dollar of assets) was 10.4% in 1997, higher than at any business cycle peak since 1959, and the capital share of income earned in the corporate sector was 21.6%, almost back to the 1959 level and sharply up from 18.4% in 1989.[29] Simply put, workers have benefited very little from the long U.S. expansion in terms of higher wages, although there has been some wage growth for lower paid workers since 1997 as unemployment fell to very low levels.

Given intense competition for markets in many sectors and the international mobility of capital, there are clearly pressures at work to maintain the relative competitiveness of national firms and industries. Seen in this context, the relative success of the Netherlands and Denmark in terms of achieving strong rates of growth of output and productivity and jobs while maintaining quite strong rates of private investment owes something to the fact that real wage growth has been kept at a level sufficient to maintain strong business investment. The collective decision of the labour movements in both countries was to give priority in bargaining to job creation and growth. While the "new corporatism" has occasionally aroused controversy, it must be noted that in the Golden Age of full employment and low inflation from the 1950s to the 1970s, unions bargained wages which closely matched productivity growth in order to maintain full employment and spur growth through investment.

To summarize, there are good reasons to believe that there is an important and positive linkage between relative equality and economic growth which runs through the way in which the labour market is organized. High levels of collective bargaining coverage,

supplemented by employment standards, produce relatively more equal wages and a low incidence of low-wage work. This can produce a climate of trust and co-operation at the workplace level, based on the fair sharing of productivity gains. Unions can also choose to place the priority in bargaining on job creation, rather than on wage growth for the already employed, as has been the case in some countries. In the Netherlands and Denmark in the 1990s, this was done through wage moderation combined with the reduction of working-time and negotiated flexibility – all of which helped to create jobs.

Finally, constructive labour-management relations can help maintain a broad social consensus around social and labour market policy issues. This has been the case in the Netherlands, where the tripartite (business/labour/government) Social and Economic Council is an extremely important voice in social policy development, including on issues related to the design and funding of income support programs. Generally speaking, consensus decisions are translated into policy, and a lack of consensus is relatively rare.

Similar, though different, consensus-building institutions exist in the other successful small European countries. In Ireland, for example, non-governmental organizations have been added to the tripartite process. Training and active labour market policy issues tend to be dealt with in such fora, where the institutional design is likely to produce some balance of social equity and economic efficiency concerns over social and labour market issues that have both social and economic significance. Neither consensus nor balance is guaranteed, and tripartite arrangements can break down in rancour and conflict, as they did in the Netherlands in the early 1980s. The central point is that social co-operation remains very much alive in some countries, and it appears to have been a major factor in producing the elusive combination of growth with social equity that is seen in some smaller countries.

Table of Contents | *Previous Section* | *Next Section*

[Home Page] [E-mail] [Page d'accueil]

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Why We Don't Have to Choose between Social Justice and Economic Growth:

The myth of the equity/efficiency trade-off

Section V
What About Globalization?

To state the obvious, there have been profound changes in the world political economy over the last 25 years: intensified competition and increased integration among the advanced industrialized countries; the increased industrial market share of some developing countries and the consequent cost-competitive pressures on some industries and workers in "the North"; the geographical extension of global capitalism through the collapse of Communism and of Third World economic nationalism; the massive growth of global financial markets; the emergence of truly transnational firms and production networks; and the growing power of international institutions such as the WTO and the IMF with a mandate to promote and enforce "free market" policies.

The emergence of a more classically "liberal" global political economy has changed the terms of the political debate. During the post-war Golden Age, there was, in most countries, a fairly broad consensus in favour of tempering market-driven inequality through progressive taxes and social transfers, and there was support for a more regulated labour market.

Increasingly however, the argument has been that regulated labour markets and generous welfare states stand in the way of growth and economic efficiency. The "stagflation" crisis of the 1970s and the productivity slowdown which dates from the same period were blamed on over-regulation and "inflexible" labour markets. Higher investment based on high rates of return to capital and "business confidence" were seen as the keys to growth, and best secured through low inflation (even at the price of high unemployment), flexible labour markets, very limited state intervention in the economy, low rates of taxation, particularly on capital and high-income earners, and reduced transfers to the unemployed.

The argument has been that change is not only desirable but inevitable. The newly unleashed forces of global competition are held to undermine labour market regulation or progressive income redistribution, particularly through high taxes, since these will result in a loss of competitiveness, capital flight and loss of investment.

Advocates of social equity have had some difficulty framing a coherent response to this restatement of classic liberal economic principles under rapidly changing circumstances. The space for purely national macro-economic policy to secure full employment and stable growth was undercut to some degree by closer capital market and trade integration. Capital mobility and structural changes such as the shift of employment to services and to

smaller, non-unionized firms reduced the power and influence of organized labour in both bargaining and the political sphere, resulting in a defensive posture towards existing welfare state institutions. Through much of the 1980s and into the 1990s, politics shifted to belief in "free markets."

In this context, some critics of globalization have argued that global financial and capital markets make full employment, strong unions and generous welfare state institutions a thing of the past with no future, since they undermine profitability and result in lost investment; the WTO and other trade and investment agreements set in motion irresistible pressures towards the downward harmonization of wages, working conditions and social standards, and so on. To greatly simplify, there has been agreement from both sides of the political spectrum that deregulated global capitalism forces states and societies to conform more and more closely to the free market model, and that success in this new context will go to those states and societies that most closely embrace the model. Proof for this proposition often cites the supposedly manifest success of the U.S. "new economy" in the 1990s, and urges countries to adopt the major features of the U.S. model.

However, Centrist, Christian Democratic and Social Democratic parties in many continental European countries have remained in or close to power in shifting coalitions and they have steered clear of directly attacking the role of collective bargaining or fundamentally undermining social security and the redistributive role of the welfare state. As noted above, national and sectoral wage bargaining arrangements covering the majority of workers remain in place, and tripartite "social bargaining" remains important in the determination of social and income security policy in some countries, and has been revived in others. The shift has not just been towards free markets, but also towards the restoration of full employment through social co-operation and active labour market policies. As a result, there remain profound socio-economic differences between advanced industrialized countries. Even in the most liberal countries, there were signs in the 1990s of a search for a new balance between growth and equity.

There are, to be sure, important barriers in the pursuit of full-employment policies in the global economy, at least until such time as there is much greater international co-ordination of macro-economic policy and exchange rates among the major economic blocs, and much more closely regulated and controlled international financial capital flows.[30]

Regarding the constraints of international competitiveness, it is indeed true that increased market integration and increased international flows of real investment strengthen the bargaining power of mobile businesses and make income redistribution at the national level more difficult. But some important caveats are in order to help explain why there is still a lot of room for choice at the national level.

Most important, the global economy is still dominated by the advanced industrialized countries, and most trade and investment flows still take place between and within the major blocs. The overall level of North-South trade is low relative to total global trade and relative to the GDP of the industrialized countries, and North-South trade in goods is more or less balanced – albeit with much higher labour content in goods shipped from the South than in the capital equipment shipped from the North to the South.[31]

Most studies have found that increased North-South trade has had some negative impacts on the wages of less skilled workers, particularly in labour-intensive manufacturing, and increased trade and international competition is associated with job loss from accelerated technological change. However, most studies find that only 10-20% of the increase in wage inequality in the U.S. over the past 20 years or so can be accounted for by increased trade, and that the impact of domestic policy-driven forces has

been far greater.[32]

The competitive downward pressures on wages and social standards from globalization can be exaggerated. Canadian workers, for example, face much more direct and intense pressures to harmonize to U.S. levels than to very low Mexican levels. In the case of Europe, the relatively high level of labour and social standards in Germany and France has greatly limited competition-driven pressures on unions and social redistribution in countries like Sweden, Denmark and the Netherlands. Moreover, in sectors which are heavily exposed to international competition, wage costs and taxes are certainly a factor, but high productivity can offset high wages, benefits and social security charges.

If that were not the case, Germany, with the highest industrial wages in the world, would be an economic basket case, rather than a very successful economy which runs a large trade surplus. And competition today is not so much about low costs (although costs are obviously important) as it is about producing innovative and high-quality goods and services that command a price premium and thus sustain high wages and social standards.

This requires innovation and highly skilled workers – the key ingredients of a knowledge-based economy that critically depends upon the accumulation of human capital.

Furthermore, it has to be taken into account that only a minority of workers are employed in sectors directly exposed to high levels of international competition, let alone competition based on low wages/low social standards. Most service industries are much less directly exposed in most instances, and not exposed at all in others.

In principle, downward competitive pressures on wages and social conditions which do arise from intensified international competition and the increased bargaining power of capital can be countered by concerted action at the regional and international levels. The "social dimension" of the European Union can be exaggerated, but some common standards have been set out with respect to conditions of employment and working conditions. Social bargaining on social and labour market policy takes place among businesses, unions and governments at the EU-wide level, and European integration is – in the minds of many political leaders, trade-unionists and others – very much about the renewal and preservation of a more egalitarian European model of society.

Further, at the EU and indeed at the OECD, initiatives are underway to stop competitive pressures from leading to an erosion of tax bases.[33] Ireland was recently compelled by the EU to modify its particularly generous tax incentives to inward foreign direct investment, and common EU tax standards being seriously considered.

Talk of the end of progressive tax/transfer systems due to greater integration is, in any case, greatly overdone in that the income redistribution brought about through taxes and transfers depends much more on the spending side than on the revenue side. (Even in the so-called Golden Age, tax systems in the Scandinavian countries were not notably more progressive than they were in the liberal countries. High levels of post-tax income equality were primarily the result of full employment, low wage inequality, and a large transfer system rather than steeply progressive income taxation.)

To summarize, the argument that the "new global economy" gives countries little or no room to pursue equity goals is exaggerated, and there are important counter-forces at play.

Table of Contents | Previous Section | Next Section

[Home Page] [E-mail] [Page d'accueil]

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Why We Don't Have to Choose between Social Justice and Economic Growth:

The myth of the equity/efficiency trade-off

Section VI
Conclusion

The central conclusion to be drawn from the recent experiences of some smaller European countries – notably Denmark and the Netherlands – is that relative economic success in today's globalized capitalism can still be achieved despite, or even because of, continuing relative income equality.

These countries have high levels of collective bargaining coverage, relatively egalitarian wage structures, and a relatively equal distribution of national income. As stressed above, these are very different societies from the U.S., Canada and the UK, and much more attractive from the perspective of those who value the goals of equality and solidarity. Further, inequality and insecurity have not been significantly increasing in the 1990s, despite some "reform" of tax systems and welfare state programs. These countries have achieved strong rates of employment growth and low unemployment, and rates of per capita GDP growth and productivity growth that match or exceed those of the U.S.

Both of these countries are highly export-oriented and highly integrated into regional (European) and even global markets. They have succeeded in international competition in the 1990s through "social pacts" which have maintained real wage growth and have been associated with the reduction of working time and the maintenance of generally good employment conditions. "Flexibility" has been negotiated, but decent standards have been preserved and inequality and low-wage work have been contained. At a minimum, it can be argued that a regulated labour market has been no barrier to high productivity and high-quality production, and there is support for the argument that high productivity is promoted by collective bargaining and developed welfare states.

It is worth considering what Canada might look like if we decided to emulate Denmark rather than the United States, and succeeded in doing so. Both government spending and taxes as a share of GDP would rise by almost 50%, allowing for an enormous expansion of income transfer programs and public services. Collective bargaining coverage would double, low-wage work would practically disappear, and the pay gap between the top and bottom of the earnings distribution would shrink from at least 4:1 to 2:1. Child poverty would be all but eliminated, and household income inequality would be hugely reduced. Furthermore, if the Danish experience is anything to go by, per capita GDP and productivity would be essentially unchanged and we would enjoy sustained growth of living standards. Making Canada look more like Denmark would constitute a rather radical social transformation.

It is true, of course, that Canada is not Denmark, and our close integration with the U.S. exposes us to harmonization pressures with respect to taxes, spending and labour market regulation that are more significant than those in the EU. But it can certainly be suggested that the barriers to such a project are more political than structural.

There are no compelling reasons why Canadians could not put job creation at the forefront of economic and social policy, based on much higher levels of co-operation among business, labour and governments. There are no compelling reasons why growing fiscal surpluses could not be devoted in much greater measure to investments in social programs and income supports, given that these investments could be expected to have positive impacts on long-term productivity and not just on greater equality of outcomes. Canada is very different from the smaller European countries on many dimensions, but that does not negate what can be learned from them about positive co-operation at the workplace, training and labour adjustment policies, real investment in the long-term unemployed, income supports for low-skilled workers, and so on. Indeed, many of these lessons have been drawn by policy makers.

Some argue – loudly and incessantly – that the liberal U.S. model will win out in global competition and force other models from the field. But the cross-country evidence is not consistent with that argument. There are indeed competitive pressures on equality generating institutions as a result of international competition, but it is far from obvious that the U.S. model of high inequality and high insecurity best promotes high productivity and good growth and employment performance. Other countries seem to have found a better way which results in shared progress, and we should learn from them.

Table of Contents | *Previous Section* | *Next Section*

[Home Page] [E-mail] [Page d'accueil]

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18

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Table of Contents | Previous Section

[Home Page] [E-mail] [Page d'accueil]